EATON CORP
Form 10-Q
October 26, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2011
Commission file number 1-1396
EATON CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Ohio | 34-0196300 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification Number) |
| Eaton Center, Cleveland, Ohio | 44114-2584 |
| (Address of principal executive offices) | (Zip Code) |

(216) 523-5000
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large accelerated filer þ | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company o |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ
There were 334.2 million Common Shares outstanding as of September 30, 2011.

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

EATON CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| (In millions except for per share data) | 2011 | 2010 | 2011 | 2010 |
| Net sales | $4,123 | $3,571 | $12,016 | $10,052 |
| Cost of products sold | 2,900 | 2,480 | 8,444 | 7,068 |
| Selling and administrative expense | 668 | 651 | 2,031 | 1,842 |
| Research and development expense | 104 | 104 | 316 | 308 |
| Interest expense-net | 29 | 33 | 92 | 102 |
| Other income-net | (10) | (2) | (30) | (11) |
| Income before income taxes | 432 | 305 | 1,163 | 743 |
| Income tax expense | 65 | 36 | 172 | 89 |
| Net income | 367 | 269 | 991 | 654 |
| Less net income for noncontrolling interests | (2) | (1) | (3) | (5) |
| Net income attributable to Eaton common shareholders | $365 | $268 | $988 | $649 |
| Net income per common share | | | | |
| Diluted | $1.07 | $0.78 | $2.86 | $1.90 |
| Basic | 1.07 | 0.80 | 2.90 | 1.93 |
| Weighted-average number of common shares outstanding | | | | |
| Diluted | 341.9 | 340.6 | 344.4 | 340.1 |
| Basic | 338.1 | 335.2 | 339.7 | 334.7 |
| Cash dividends paid per common share | $0.34 | $0.29 | $1.02 | $0.79 |

Net income per common share, weighted-average number of common shares outstanding and cash dividends paid per common share have been restated to give effect to the two-for-one stock split. See Note 1 for additional information.
The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

| (In millions) | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Assets | | |
| Current assets | | |
| Cash | $278 | $333 |
| Short-term investments | 536 | 838 |
| Accounts receivable-net | 2,549 | 2,239 |
| Inventory | 1,769 | 1,564 |
| Other current assets | 601 | 532 |
| Total current assets | 5,733 | 5,506 |
| Property, plant and equipment-net | 2,537 | 2,477 |
| Other noncurrent assets | | |
| Goodwill | 5,571 | 5,454 |
| Other intangible assets | 2,253 | 2,272 |
| Deferred income taxes | 971 | 1,001 |
| Other assets | 562 | 542 |
| Total assets | $17,627 | $17,252 |
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Short-term debt | $86 | $72 |
| Current portion of long-term debt | 321 | 4 |
| Accounts payable | 1,527 | 1,408 |
| Accrued compensation | 401 | 465 |
| Other current liabilities | 1,445 | 1,284 |
| Total current liabilities | 3,780 | 3,233 |
| Noncurrent liabilities | | |
| Long-term debt | 3,368 | 3,382 |
| Pension liabilities | 1,182 | 1,429 |
| Other postretirement benefits liabilities | 634 | 743 |
| Deferred income taxes | 456 | 487 |
| Other noncurrent liabilities | 461 | 575 |
| Total noncurrent liabilities | 6,101 | 6,616 |
| Shareholders' equity | | |
| Eaton shareholders' equity | 7,723 | 7,362 |
| Noncontrolling interests | 23 | 41 |
| Total equity | 7,746 | 7,403 |
| Total liabilities and equity | $17,627 | $17,252 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine months ended September 30 | |
|---|---|---|
| (In millions) | 2011 | 2010 |
| Operating activities | | |
| Net income | $991 | $654 |
| Adjustments to reconcile to net cash provided by operating activities | | |
| Depreciation and amortization | 419 | 413 |
| Contributions to pension plans | (341) | (378) |
| Contributions to other postretirement benefits plans | (150) | (61) |
| Changes in working capital | (290) | (70) |
| Other-net | 60 | 169 |
| Net cash provided by operating activities | 689 | 727 |
| | | |
| Investing activities | | |
| Cash paid for acquisitions of businesses | (298) | (172) |
| Capital expenditures for property, plant and equipment | (384) | (207) |
| Sales (purchases) of short-term investments-net | 272 | (47) |
| Other-net | 1 | (6) |
| Net cash used in investing activities | (409) | (432) |
| | | |
| Financing activities | | |
| Borrowings with original maturities of more than three months | | |
| Proceeds | 352 | 55 |
| Payments | (14) | (59) |
| Payments with original maturities of less than three months-net (primarily commercial paper) | (38) | (19) |
| Cash dividends paid | (348) | (265) |
| Exercise of employee stock options | 66 | 60 |
| Repurchase of shares | (343) | — |
| Other-net | (4) | 2 |
| Net cash used in financing activities | (329) | (226) |
| | | |
| Effect of foreign exchange rate changes on cash | (6) | (14) |
| Total (decrease) increase in cash | (55) | 55 |
| Cash at the beginning of the period | 333 | 340 |
| Cash at the end of the period | $278 | $395 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EATON CORPORATION
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Amounts are in millions unless indicated otherwise (per share data assume dilution).

Note 1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Eaton Corporation (Eaton or Company) have been prepared in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, in the opinion of management, all adjustments (consisting of normal recurring accruals) have been made that are necessary for a fair presentation of the condensed consolidated financial statements for the interim periods.

This Form 10-Q should be read in conjunction with the consolidated financial statements and related notes included in Eaton's 2010 Form 10-K. The interim period results are not necessarily indicative of the results to be expected for the full year. Management has evaluated subsequent events through the date this Form 10-Q was filed with the SEC.

On January 27, 2011, Eaton's Board of Directors announced a two-for-one stock split of the Company's common shares effective in the form of a 100% stock dividend. The record date for the stock split was February 7, 2011, and the additional shares were distributed on February 28, 2011. Accordingly, all per share amounts, weighted-average shares outstanding, and equity-based compensation presented in the condensed consolidated financial statements and notes have been adjusted retroactively to reflect the stock split.

Certain prior year amounts have been reclassified to conform to the current year presentation.

Note 2. ACQUISITIONS OF BUSINESSES

In 2011 and 2010, Eaton acquired businesses and entered into a joint venture in separate transactions. The Consolidated Statements of Income include the results of these businesses from the dates of the transactions or formation. These transactions are summarized below:

| Acquired businesses and joint venture | Date of transaction | Business segment | Annual sales |
|---|---|---|---|
| IE Power, Inc.<br>A Canada-based provider of high power inverters for a variety of mission-critical applications including solar, wind and battery energy storage. | August 31, 2011 | Electrical Americas | $5 for 2010 |
| E. Begerow GmbH & Co. KG<br>A Germany-based system provider of advanced liquid filtration solutions. This business develops and produces technologically innovative filter media and filtration systems for food and beverage, chemical, pharmaceutical and industrial applications. | August 15, 2011 | Hydraulics | $84 for 2010 |
| ACTOM Low Voltage<br>A South Africa manufacturer and supplier of motor control components, engineered electrical distribution systems and uninterruptible power supply (UPS) systems. | June 30, 2011 | Electrical Rest of World | $65 for the year ended May 31, 2011 |
| C.I. ESI de Colombia S.A.<br>A Colombia-based distributor of industrial electrical equipment and engineering services in the Colombian market, focused on oil and gas, mining, and industrial and commercial construction. | June 2, 2011 | Electrical Americas | $8 for 2010 |
| Internormen Technology Group | May 12, 2011 | Hydraulics | $55 for 2010 |

| | | | |
|---|---|---|---|
| A Germany-based manufacturer of hydraulic filtration and instrumentation with sales and distribution subsidiaries in China, the United States, India and Brazil. | | | |
| Eaton-SAMC (Shanghai) Aircraft Conveyance System Manufacturing Co., Ltd.<br>A 49%-owned joint venture in China focusing on the design, development, manufacturing and support of fuel and hydraulic conveyance systems for the global civil aviation market. | March 8, 2011 | Aerospace | New joint venture |

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| Acquired businesses and joint venture | Date of transaction | Business segment | Annual sales |
|---|---|---|---|
| Tuthill Coupling Group<br>A United States and France-based manufacturer of pneumatic and hydraulic quick coupling solutions and leak-free connectors used in industrial, construction, mining, defense, energy and power applications. | January 1, 2011 | Hydraulics | $35 for the year ended November 30, 2010 |
| Chloride Phoenixtec Electronics<br>A China manufacturer of UPS systems. Eaton acquired the remaining shares to increase its ownership from 50% to 100%. | October 12, 2010 | Electrical Rest of World | $25 for the year ended September 30, 2010 |
| CopperLogic, Inc.<br>A United States-based manufacturer of electrical and electromechanical systems. | October 1, 2010 | Electrical Americas | $35 for the year ended September 30, 2010 |
| Wright Line Holding, Inc.<br>A United States provider of customized enclosures, rack systems, and air-flow management systems to store, power, and secure mission-critical IT data center electronics. | August 25, 2010 | Electrical Americas | $101 for the year ended June 30, 2010 |
| EMC Engineers, Inc.<br>A United States energy engineering and energy services company that delivers energy efficiency solutions for a wide range of governmental, educational, commercial and industrial facilities. | July 15, 2010 | Electrical Americas | $24 for 2009 |

Note 3. ACQUISITION INTEGRATION AND RESTRUCTURING CHARGES

Acquisition Integration Charges

Eaton incurs charges related to the integration of acquired businesses. A summary of these charges follows:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Business segment | | | | |
| Electrical Americas | $3 | $— | $7 | $2 |
| Electrical Rest of World | — | 6 | 1 | 20 |
| Hydraulics | 1 | — | 1 | — |
| Aerospace | — | 1 | — | 3 |
| Total integration charges before income taxes | $4 | $7 | $9 | $25 |
| After-tax integration charges | $2 | $4 | $6 | $16 |
| Per common share | $0.01 | $0.01 | $0.02 | $0.05 |

Charges in 2011 were related primarily to CopperLogic, Wright Line Holding and EMC Engineers. Charges in 2010 were related primarily to Moeller and Phoenixtec. These charges were included in Cost of products sold or Selling and administrative expense, as appropriate. In Note 13. Business Segment Information, the charges reduced Operating profit of the related business segment.

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Workforce Reduction and Plant Closing Liabilities

The following table summarizes the liabilities related to acquisition integration, plant closing charges, and other workforce reduction actions:

| | Workforce reductions | | Plant closing | |
|---|---|---|---|---|
| | Employees | Dollars | and other | Total |
| Balance at January 1, 2011 | 327 | $11 | $5 | $16 |
| Liabilities recognized | 79 | 2 | 7 | 9 |
| Utilized | (258) | (7) | (10) | (17) |
| Balance at September 30, 2011 | 148 | $6 | $2 | $8 |

Note 4. GOODWILL

A summary of goodwill follows:

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Electrical Americas | $2,059 | $2,061 |
| Electrical Rest of World | 1,001 | 985 |
| Hydraulics | 1,111 | 1,007 |
| Aerospace | 1,041 | 1,037 |
| Truck | 150 | 151 |
| Automotive | 209 | 213 |
| Total goodwill | $5,571 | $5,454 |

The increase in goodwill in 2011 was primarily due to businesses acquired during 2011, partially offset by the impact of foreign currency translation. For additional information regarding acquired businesses, see Note 2.

Assessing Goodwill for Impairment

In September 2011, the Financial Accounting Standards Board issued a revised standard on testing goodwill for impairment. The revised standard allows an entity to first assess the carrying value of goodwill based on qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than the reporting unit's carrying amount. If, based on a qualitative assessment, the fair value of a reporting unit is more likely than not lower than its carrying value, the entity must then test goodwill from a quantitative perspective similar to prior guidance. This standard is effective for 2012, with early adoption permitted. Eaton elected to adopt this standard for its 2011 annual impairment testing.

Goodwill is tested for impairment annually as of July 1 at the reporting unit level, which is equivalent to Eaton's operating segments. As disclosed in Eaton's 2010 Form 10-K, impairment testing for 2010 was performed from a quantitative perspective using a discounted cash flow model to estimate the fair value of each operating segment. For 2010, the fair value of Eaton's reporting units substantially exceeded the respective carrying values.

Impairment testing for 2011 was performed by assessing certain qualitative trends and factors, including projected market outlook and growth rates, forecasted and actual sales and operating profit margins, discount rates, industry data and other relevant qualitative factors. These trends and factors were compared to and based on the assumptions used in the quantitative assessment performed in 2010. For 2011, it is more likely than not that the fair value of Eaton's reporting units continues to substantially exceed the respective carrying amount.

Note 5. DEBT

On June 16, 2011, Eaton issued $300 floating rate senior unsecured Notes due June 16, 2014 (the Notes). The Notes bear interest annually at a floating rate, reset quarterly, equal to the three-month LIBOR rate for U.S. dollars plus .33% (33 basis points). Interest is payable quarterly in arrears. The Notes contain a provision which requires the Company to make an offer to purchase all or any part of the Notes at a purchase price of 101% of the principal amount plus accrued and unpaid interest if certain change of control events occur. The Notes are subject to customary non-financial covenants.

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Eaton refinanced a $500, five-year revolving credit facility in June 2011 (the Facility). This refinancing maintains long-term revolving credit facilities at a total of $1.5 billion. The revolving credit facility is used to support commercial paper borrowings. The Facility will expire June 16, 2016, replacing a $500 facility that had been set to expire on September 1, 2011.

Note 6. RETIREMENT BENEFITS PLANS

The components of retirement benefits expense follow:

| | Three months ended September 30 | | | | | |
|---|---|---|---|---|---|---|
| | United States pension benefit expense | | Non-United States pension benefit expense | | Other postretirement benefits expense | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Service cost | $23 | $20 | $12 | $10 | $4 | $4 |
| Interest cost | 33 | 33 | 19 | 17 | 10 | 11 |
| Expected return on plan assets | (41) | (39) | (17) | (15) | — | — |
| Amortization | 19 | 13 | 3 | 2 | 3 | 3 |
| | 34 | 27 | 17 | 14 | 17 | 18 |
| Curtailment loss | — | — | 1 | — | — | — |
| Settlement loss | 5 | 4 | — | — | — | — |
| Total expense | $39 | $31 | $18 | $14 | $17 | $18 |

| | Nine months ended September 30 | | | | | |
|---|---|---|---|---|---|---|
| | United States pension benefit expense | | Non-United States pension benefit expense | | Other postretirement benefits expense | |
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| Service cost | $69 | $60 | $37 | $29 | $12 | $12 |
| Interest cost | 99 | 99 | 59 | 51 | 30 | 34 |
| Expected return on plan assets | (123) | (117) | (53) | (46) | — | — |
| Amortization | 57 | 39 | 9 | 6 | 9 | 8 |
| | 102 | 81 | 52 | 40 | 51 | 54 |
| Curtailment loss | — | — | 1 | — | — | — |
| Settlement loss | 12 | 13 | 3 | — | — | — |
| Total expense | $114 | $94 | $56 | $40 | $51 | $54 |

During the second quarter of 2011, Eaton contributed $100 into a Voluntary Employee Benefit Association trust for the pre-funding of postretirement Medicare Part D prescription drug benefits for the Company's eligible United States employees and retirees. The contribution was made as part of the Company's strategy to improve the funding of its pension and postretirement obligations. As part of that strategy, in the first quarter of 2011, the Company contributed $250 to its United States qualified pension plans.

Note 7. LEGAL CONTINGENCIES

In December 2010, a Brazilian court held that a judgment obtained by a Brazilian company, Raysul, against another Brazilian company, Saturnia, which was sold by Eaton in 2006, could be enforced against Eaton Ltda. This judgment is based on an alleged violation of an agency agreement between Raysul and Saturnia. At September 30, 2011, the Company has a total accrual of 67 Brazilian Reais related to this matter, comprised of 60 Brazilian Reais recognized in the fourth quarter of 2010 ($32 based on current exchange rates) with an additional 7 Brazilian Reais recognized in 2011 ($4 based on current exchange rates) due to subsequent accruals for interest and inflation. The Company expects that any sum it may be required to pay in connection with this matter will not exceed the amount of the recorded liability. In 2010, Eaton filed motions for clarification with the Brazilian court of appeals which were denied on April 6, 2011. Eaton Holding and Eaton Ltda. filed appeals on various issues to the Superior Court of Justice in Brasilia. On September 27, 2011, the Superior Court of Justice accepted two of the appeals and will hear those appeals in due course. Another appeal remains pending in the lower appellate court.

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On October 5, 2006, ZF Meritor LLC and Meritor Transmission Corporation (collectively, Meritor) filed an action against Eaton in the United States District Court for Delaware. The action sought damages, which would be trebled under United States antitrust laws, as well as injunctive relief and costs. The suit alleged that Eaton engaged in anti-competitive conduct against Meritor in the sale of heavy-duty truck transmissions in North America. Following a four week trial on liability only, on October 8, 2009, the jury returned a verdict in favor of Meritor. Eaton firmly believes that it competes fairly and honestly for business in the marketplace, and that at no time did it act in an anti-competitive manner. During an earlier stage in the case, the judge concluded that damage estimates contained in a report filed by Meritor were not based on reliable data and the report was specifically excluded from the case. On November 3, 2009, Eaton filed a motion for judgment as a matter of law and to set aside the verdict. That motion was denied on March 10, 2011. On March 14, 2011, Eaton filed a motion for entry of final judgment of liability, zero damages and no injunctive relief. That motion was denied on June 9, 2011. On August 19, 2011, the Court entered final judgment of liability but awarded zero damages to plaintiffs. The Court also entered an injunction prohibiting Eaton from offering rebates or other incentives based on purchasing targets but stayed the injunction pending appeal. Eaton has appealed the liability finding and the injunction to the Third Circuit Court of Appeals. Meritor has cross-appealed the finding of zero damages.

Eaton is subject to a broad range of claims, administrative and legal proceedings such as lawsuits that relate to contractual allegations, tax audits, patent infringement, personal injuries (including asbestos claims), antitrust matters and employment-related matters. Although it is not possible to predict with certainty the outcome or cost of these matters, the Company believes they will not have a material adverse effect on the consolidated financial statements.

## Note 8. INCOME TAXES

The effective income tax rate for the third quarter of 2011 was 15.2% compared to 11.7% for the third quarter of 2010 and 14.8% for the first nine months of 2011 compared to 12.0% for the first nine months of 2010. Higher effective tax rates in both the third quarter and first nine months of 2011 were primarily attributable to greater levels of income in high tax jurisdictions, particularly in the United States and Brazil, due to improved economic and market conditions. The effective income tax rate for the third quarter of 2011 was also favorably impacted by positive adjustments to the tax provision for 2010 tax returns filed during the third quarter in the United States and international tax jurisdictions.

## Note 9. EQUITY

Eaton has a common share repurchase program (2007 Program) that authorizes the repurchase of 10 million common shares. During the first nine months of 2011, 8.3 million common shares were repurchased under the 2007 Program in the open market at a total cost of $343. On September 28, 2011, Eaton's Board of Directors approved a common share repurchase program (2011 Program) which replaced the 2007 Program and authorizes the purchase of up to 20 million shares, not to exceed an aggregate purchase price of $1.25 billion. The common shares are expected to be repurchased over time, depending on market conditions, the market price of common shares, capital levels and other considerations. No common shares were repurchased in the open market in the first nine months of 2010.

The changes in Shareholders' equity follow:

| | Eaton shareholders' equity | Noncontrolling interests | Total equity |
|---|---|---|---|
| Balance at December 31, 2010 | $7,362 | $41 | $7,403 |
| Net income | 988 | 3 | 991 |
| Other comprehensive loss | (67) | — | (67) |
| Total comprehensive income | 921 | 3 | 924 |
| Cash dividends paid | (348) | (7) | (355) |
| Issuance of shares under equity-based compensation plans-net | 131 | — | 131 |
| Business divestiture | — | (14) | (14) |
| Repurchase of shares | (343) | — | (343) |

| | | | |
|---|---|---|---|
| Balance at September 30, 2011 | $7,723 | $23 | $7,746 |

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Comprehensive (Loss) Income

Comprehensive (loss) income consists primarily of net income, foreign currency translation and related hedging instruments, changes in unrecognized costs of pension and other postretirement benefits, and changes in the effective portion of open derivative contracts designated as cash flow hedges. The following table summarizes the components of Comprehensive (loss) income:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net income | $367 | $269 | $991 | $654 |
| Foreign currency translation and related hedging instruments | (449) | 419 | (111) | (64) |
| Pensions and other postretirement benefits | 34 | 4 | 69 | 51 |
| Cash flow hedges | (20) | 7 | (25) | (2) |
| Other comprehensive (loss) income | (435) | 430 | (67) | (15) |
| Total comprehensive (loss) income | (68) | 699 | 924 | 639 |
| Adjustment for comprehensive income attributable to noncontrolling interests | (2) | (1) | (3) | (5) |
| Total Comprehensive (loss) income attributable to Eaton common shareholders | $(70) | $698 | $921 | $634 |

Net Income per Common Share

A summary of the calculation of net income per common share attributable to common shareholders follows:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| (Shares in millions) | 2011 | 2010 | 2011 | 2010 |
| Net income attributable to Eaton common shareholders | $365 | $268 | $988 | $649 |
| Weighted-average number of common shares outstanding-diluted | 341.9 | 340.6 | 344.4 | 340.1 |
| Less dilutive effect of stock options and restricted stock awards | 3.8 | 5.4 | 4.7 | 5.4 |
| Weighted-average number of common shares outstanding-basic | 338.1 | 335.2 | 339.7 | 334.7 |
| Net income per common share | | | | |
| Diluted | $1.07 | $0.78 | $2.86 | $1.90 |
| Basic | 1.07 | 0.80 | 2.90 | 1.93 |

For the third quarter and first nine months of 2011, 2.7 million and 1.1 million stock options, respectively, were excluded from the calculation of diluted net income per common share because the exercise price of the options exceeded the average market price of the common shares during the period and their effect, accordingly, would have been antidilutive. For the third quarter and first nine months of 2010, 7.0 million and 8.8 million stock options, respectively, were excluded from the calculation of diluted net income per common share because the exercise price of the options exceeded the average market price of the common shares during the period and their effect, accordingly, would have been antidilutive.

Note 10. FAIR VALUE MEASUREMENTS

Fair value is measured based on an exit price, representing the amount that would be received to sell an asset or paid to satisfy a liability in an orderly transaction between market participants. Fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, a fair value hierarchy is established, which categorizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

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A summary of financial instruments recognized at fair value, and the fair value measurements used, follows:

| | Total | Quoted prices in active markets for identical assets (Level 1) | Other observable inputs (Level 2) | Unobservable inputs (Level 3) |
|---|---|---|---|---|
| September 30, 2011 | | | | |
| Cash | $278 | $278 | $— | $— |
| Short-term investments | 536 | 536 | — | — |
| Net derivative contracts | 25 | — | 25 | — |
| Long-term debt converted to floating interest rates by interest rate swaps | 67 | — | 67 | — |
| December 31, 2010 | | | | |
| Cash | $333 | $333 | $— | $— |
| Short-term investments | 838 | 838 | — | — |
| Net derivative contracts | 69 | — | 69 | — |
| Long-term debt converted to floating interest rates by interest rate swaps | 42 | — | 42 | — |

Eaton values its financial instruments using an industry standard market approach, in which prices and other relevant information is generated by market transactions involving identical or comparable assets or liabilities. No financial instruments were recognized using unobservable inputs.

Other Fair Value Measurements

Long-term debt and the current portion of long-term debt had a carrying value of $3,689 and fair value of $4,324 at September 30, 2011 compared to $3,386 and $3,787, respectively, at December 31, 2010.

Note 11. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

In the normal course of business, Eaton is exposed to certain risks related to fluctuations in interest rates, foreign currency exchange rates and commodity prices. The Company uses various derivative and non-derivative financial instruments, primarily interest rate swaps, foreign currency forward exchange contracts, foreign currency swaps and, to a lesser extent, commodity contracts, to manage risks from these market fluctuations. The instruments used by Eaton are straightforward, non-leveraged instruments. The counterparties to these instruments are financial institutions with strong credit ratings. Eaton maintains control over the size of positions entered into with any one counterparty and regularly monitors the credit rating of these institutions. Such instruments are not purchased and sold for trading purposes.

Derivative financial instruments are accounted for at fair value and recognized as assets or liabilities in the Condensed Consolidated Balance Sheets. Accounting for the gain or loss resulting from the change in the fair value of the derivative financial instrument depends on whether it has been designated, and is effective, as part of a hedging relationship and, if so, as to the nature of the hedging activity. Eaton formally documents all relationships between derivative financial instruments accounted for as hedges and the hedged item, as well as its risk-management objective and strategy for undertaking the hedge transaction. This process includes linking all derivative financial instruments to a recognized asset or liability, specific firm commitment, forecasted transaction, or net investment in a foreign operation. These financial instruments can be designated as:

- Hedges of the change in the fair value of a recognized fixed-rate asset or liability, or the firm commitment to acquire such an asset or liability (a fair value hedge); for these hedges, the gain or loss from the derivative financial instrument, as well as the offsetting loss or gain on the hedged item attributable to the hedged risk, are recognized in income during the period of change in fair value.

- Hedges of the variable cash flows of a recognized variable-rate asset or liability, or the forecasted acquisition of such an asset or liability (a cash flow hedge); for these hedges, the effective portion of the gain or loss from the derivative financial instrument is recognized in Accumulated other comprehensive income (loss) and reclassified to income in the same period when the gain or loss on the hedged item is included in income.

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- Hedges of the foreign currency exposure related to a net investment in a foreign operation (a net investment hedge); for these hedges, the effective portion of the gain or loss from the derivative financial instrument is recognized in Accumulated other comprehensive income (loss) and reclassified to income in the same period when the gain or loss related to the net investment in the foreign operation is included in income.

The gain or loss from a derivative financial instrument designated as a hedge that is effective is classified in the same line of the Consolidated Statements of Income as the offsetting loss or gain on the hedged item. The change in fair value of a derivative financial instrument that is not effective as a hedge is immediately recognized in income.

For derivatives that are not designated as a hedge, any gain or loss is immediately recognized in income. The majority of derivatives used in this manner relate to risks resulting from assets or liabilities denominated in a foreign currency and certain commodity contracts that arise in the normal course of business. During the third quarter and first nine months of 2011, Eaton incurred losses associated with commodity hedge contracts of $23 and $19, respectively. These losses were incurred due to significant declines in metal prices during primarily the last two weeks in September. Gains and losses associated with commodity hedge contracts are reported in Cost of products sold.

Derivative Financial Statement Impacts

The fair value of derivative financial instruments recognized in the Condensed Consolidated Balance Sheets follows:

| | Notional amount | Other current assets | Other long-term assets | Other current liabilities | Type of hedge | Term |
|---|---|---|---|---|---|---|
| September 30, 2011 | | | | | | |
| Derivatives designated as hedges | | | | | | |
| Fixed-to-floating interest rate swaps | $540 | $— | $67 | $— | Fair value | 2 to 23 years |
| Foreign currency exchange contracts | 331 | 5 | — | 12 | Cash flow | 12 to 36 months |
| Commodity contracts | 50 | — | — | 12 | Cash flow | 12 months |
| Total | | $5 | $67 | $24 | | |
| | | | | | | |
| Derivatives not designated as hedges | | | | | | |
| Foreign currency exchange contracts | $2,845 | $24 | | $25 | | 12 months |
| Commodity contracts | 114 | — | | 22 | | 12 months |
| Total | | $24 | | $47 | | |
| | | | | | | |
| December 31, 2010 | | | | | | |
| Derivatives designated as hedges | | | | | | |
| Fixed-to-floating interest rate swaps | $540 | $— | $42 | $— | Fair value | 2 to 23 years |
| Foreign currency exchange contracts | 227 | 4 | — | 5 | Cash flow | 12 to 36 months |
| Commodity contracts | 39 | 8 | — | — | Cash flow | 12 months |
| Cross currency swaps | 75 | 2 | — | — | Net investment | 12 months |
| Total | | $14 | $42 | $5 | | |
| | | | | | | |
| Derivatives not designated as hedges | | | | | | |
| Foreign currency exchange contracts | $2,777 | $20 | | $19 | | 12 months |
| Commodity contracts | 102 | 17 | | — | | 12 months |

| | | |
|---|---|---|
| Total | $37 | $19 |

The foreign currency exchange contracts shown in the table above as derivatives not designated as hedges are primarily contracts entered into to manage foreign currency volatility or exposure on intercompany sales and loans. While Eaton does not elect hedge accounting treatment for these derivatives, Eaton targets managing 100% of the intercompany balance sheet exposure to minimize the effect of currency volatility related to the movement of goods and services in the normal course of its operations. This activity represents the great majority of these foreign currency exchange contracts.

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Amounts recognized in Accumulated other comprehensive income (loss) follow:

| | Three months ended September 30 | | | |
|---|---|---|---|---|
| | 2011 | | 2010 | |
| | Gain (loss) recognized in Accumulated other comprehensive income (loss) | Gain (loss) reclassified from Accumulated other comprehensive income (loss) | Gain (loss) recognized in Accumulated other comprehensive income (loss) | Gain (loss) reclassified from Accumulated other comprehensive income (loss) |
| Derivatives designated as cash flow hedges | | | | |
| Foreign currency exchange contracts | $(7) | $(1) | $3 | $1 |
| Commodity contracts | (12) | 2 | 5 | — |
| Derivatives designated as net investment hedges | | | | |
| Cross currency swaps | — | — | (16) | — |
| Total | $(19) | $1 | $(8) | $1 |

| | Nine months ended September 30 | | | |
|---|---|---|---|---|
| | 2011 | | 2010 | |
| | Gain (loss) recognized in Accumulated other comprehensive income (loss) | Gain (loss) reclassified from Accumulated other comprehensive income (loss) | Gain (loss) recognized in Accumulated other comprehensive income (loss) | Gain (loss) reclassified from Accumulated other comprehensive income (loss) |
| Derivatives designated as cash flow hedges | | | | |
| Foreign currency exchange contracts | $(6) | $(1) | $2 | $1 |
| Commodity contracts | (13) | 7 | 2 | 5 |
| Derivatives designated as net investment hedges | | | | |
| Cross currency swaps | 1 | — | (12) | — |
| Total | $(18) | $6 | $(8) | $6 |

Gains and losses reclassified from Accumulated other comprehensive income (loss) to the Consolidated Statements of Income were recognized in Cost of products sold.

Amounts recognized in net income follow:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Derivatives designated as fair value hedges | | | | |
| Fixed-to-floating interest rate swaps | $23 | $13 | $25 | $49 |
| Related long-term debt converted to floating interest rates by interest rate swaps | (23) | (13) | (25) | (49) |
| | $— | $— | $— | $— |

Gains and losses described above were recognized in Interest expense.

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Note 12. INVENTORY

The components of inventory follow:

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Raw materials | $747 | $651 |
| Work-in-process | 243 | 229 |
| Finished goods | 907 | 800 |
| Inventory at FIFO | 1,897 | 1,680 |
| Excess of FIFO over LIFO cost | (128) | (116) |
| Total inventory | $1,769 | $1,564 |

Note 13. BUSINESS SEGMENT INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated on a regular basis by the chief operating decision maker, or decision making group, in deciding how to allocate resources to an individual segment and in assessing performance. Eaton's operating segments are Electrical Americas, Electrical Rest of World, Hydraulics, Aerospace, Truck and Automotive. For additional information regarding Eaton's business segments, see Note 14 to the Consolidated Financial Statements contained in the 2010 Form 10-K.

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EATON CORPORATION
BUSINESS SEGMENT INFORMATION

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net sales | | | | |
| Electrical Americas | $1,074 | $967 | $3,071 | $2,663 |
| Electrical Rest of World | 755 | 707 | 2,285 | 1,980 |
| Hydraulics | 717 | 583 | 2,130 | 1,641 |
| Aerospace | 420 | 390 | 1,218 | 1,136 |
| Truck | 715 | 534 | 1,964 | 1,479 |
| Automotive | 442 | 390 | 1,348 | 1,153 |
| Total net sales | $4,123 | $3,571 | $12,016 | $10,052 |
| | | | | |
| Segment operating profit | | | | |
| Electrical Americas | $156 | $141 | $432 | $366 |
| Electrical Rest of World | 62 | 81 | 209 | 183 |
| Hydraulics | 109 | 76 | 335 | 207 |
| Aerospace | 71 | 60 | 166 | 157 |
| Truck | 139 | 74 | 349 | 179 |
| Automotive | 62 | 39 | 167 | 120 |
| Total segment operating profit | 599 | 471 | 1,658 | 1,212 |
| | | | | |
| Corporate | | | | |
| Amortization of intangible assets | (47) | (46) | (143) | (134) |
| Interest expense-net | (29) | (33) | (92) | (102) |
| Pension and other postretirement benefits expense | (35) | (30) | (105) | (91) |
| Other corporate expense-net | (56) | (57) | (155) | (142) |
| Income before income taxes | 432 | 305 | 1,163 | 743 |
| Income tax expense | 65 | 36 | 172 | 89 |
| Net income | 367 | 269 | 991 | 654 |
| Less net income for noncontrolling interests | (2) | (1) | (3) | (5) |
| Net income attributable to Eaton common shareholders | $365 | $268 | $988 | $649 |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Amounts are in millions of dollars or shares unless indicated otherwise (per share data assume dilution).

TWO-FOR-ONE STOCK SPLIT

On January 27, 2011, Eaton's Board of Directors announced a two-for-one split of the Company's common shares effective in the form of a 100% stock dividend. The record date for the stock split was February 7, 2011, and the additional shares were distributed on February 28, 2011. Accordingly, all share and per share data have been adjusted retroactively to reflect the stock split.

COMPANY OVERVIEW

Eaton Corporation is a diversified power management company with 2010 sales of $13.7 billion. The Company is a global technology leader in electrical components and systems for power quality, distribution and control; hydraulics components, systems and services for industrial and mobile equipment; aerospace fuel, hydraulics and pneumatic systems for commercial and military use; and truck and automotive drivetrain and powertrain systems for performance, fuel economy and safety. Eaton has approximately 73,000 employees in over 50 countries, and sells products to customers in more than 150 countries.

Eaton acquired certain businesses that affect comparability on a year over year basis. The Consolidated Statements of Income include the results of these businesses from the dates of the transactions or formation. For a list of business acquisitions and joint ventures impacting the comparative periods, see Note 2 to the Condensed Consolidated Financial Statements.

A summary of Eaton's Net sales, Net income attributable to Eaton common shareholders, and Net income per common share-diluted follows:

| | Three months ended September 30 | | Nine months ended September 30 | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Net sales | $4,123 | $3,571 | $12,016 | $10,052 |
| Net income attributable to Eaton common shareholders | 365 | 268 | 988 | 649 |
| Net income per common share-diluted | $1.07 | $0.78 | $2.86 | $1.90 |

RESULTS OF OPERATIONS

The following discussion of Consolidated Financial Results and Business Segment Results of Operations includes certain non-GAAP financial measures. These financial measures include operating earnings, operating earnings per common share, and operating profit before acquisition integration charges for each business segment, each of which excludes amounts that differ from the most directly comparable measure calculated in accordance with generally accepted accounting principles (GAAP). A reconciliation of each of these financial measures to the most directly comparable GAAP measure is included in the table below and in the discussion of the operating results of each business segment. Management believes that these financial measures are useful to investors because they exclude transactions of an unusual nature, allowing investors to more easily compare Eaton's financial performance period to period. Management uses this information in monitoring and evaluating the on-going performance of Eaton and each business segment.

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Consolidated Financial Results

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $4,123 | $3,571 | 15 % | $12,016 | $10,052 | 20 % |
| Gross profit | 1,223 | 1,091 | 12 % | 3,572 | 2,984 | 20 % |
| Percent of net sales | 29.7 % | 30.6 % | | 29.7 % | 29.7 % | |
| Income before income taxes | 432 | 305 | 42 % | 1,163 | 743 | 57 % |
| Net income | $367 | $269 | 36 % | $991 | $654 | 52 % |
| Less net income for noncontrolling interests | (2 ) | (1 ) | | (3 ) | (5 ) | |
| Net income attributable to Eaton common shareholders | 365 | 268 | 36 % | 988 | 649 | 52 % |
| Excluding acquisition integration charges (after-tax) | 2 | 4 | | 6 | 16 | |
| Operating earnings | $367 | $272 | 35 % | $994 | $665 | 49 % |
| Net income per common share-diluted | $1.07 | $0.78 | 37 % | $2.86 | $1.90 | 51 % |
| Excluding per share impact of acquisition integration charges (after-tax) | 0.01 | 0.01 | | 0.02 | 0.05 | |
| Operating earnings per common share | $1.08 | $0.79 | 37 % | $2.88 | $1.95 | 48 % |

Net Sales

Net sales in the third quarter of 2011 increased by 15% compared to the third quarter of 2010. The sales increase was due to an increase of 11% in core sales, 2% from acquisitions of businesses, and 2% from the favorable impact of foreign exchange. Net sales in the first nine months of 2011 increased by 20% compared to the first nine months of 2010. The sales increase was due to and increase of 14% in core sales, 4% from the favorable impact of foreign exchange, and 2% from acquisitions of businesses. The increase in core sales in both the third quarter and first nine months of 2011 reflects the continuing global expansion of the Company's markets, which increased 11% in the third quarter of 2011 compared to the same period in 2010, and the global economic recovery from the depressed levels of 2009. Eaton continues to anticipate that its end markets will grow by 11% for all of 2011.

Gross Profit

Gross profit increased by 12% in the third quarter of 2011 compared to the third quarter of 2010. Gross profit margin decreased 0.9 percentage points from 30.6% in the third quarter of 2010 to 29.7% in the third quarter of 2011. Gross profit increased by 20% in the first nine months of 2011 compared to the first nine months of 2010. Gross profit margin was 29.7% for the first nine months of both 2011 and 2010. The gross profit margin in both the third quarter and first nine months of 2011 was positively impacted by higher sales volumes and the benefits of substantial changes in the Company’s cost structure implemented in the past two years. These benefits were partially offset by higher raw material and commodity costs, including losses incurred of $23 associated with commodity hedge contracts due to significant declines in metal prices primarily during the last two weeks in September. For additional information related to derivatives, see Note 11 to the Condensed Consolidated Financial Statements.

Income Taxes

The effective income tax rate for the third quarter of 2011 was 15.2% compared to 11.7% for the third quarter of 2010 and 14.8% for the first nine months of 2011 compared to 12.0% for the first nine months of 2010. Higher effective tax rates in both the third quarter and first nine months of 2011 were primarily attributable to greater levels of income in high tax jurisdictions, particularly in the United States and Brazil, due to improved economic and market conditions. The effective income tax rate for the third quarter of 2011 was also favorably impacted by positive adjustments to the tax provision for 2010 tax returns filed during the third quarter in the United States and international tax jurisdictions.

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Net Income

Net income attributable to Eaton common shareholders of $365 in the third quarter of 2011 increased 36% compared to net income of $268 in the third quarter of 2010, and Net income per common share of $1.07 in the third quarter of 2011 increased 37% over Net income per common share of $0.78 in the third quarter of 2010. Net income attributable to Eaton common shareholders of $988 in the first nine months of 2011 increased 52% compared to net income of $649 in the first nine months of 2010, and Net income per common share of $2.86 in the first nine months of 2011 increased 51% over Net income per common share of $1.90 in the first nine months of 2010. The increase in both the third quarter and first nine months of 2011 was primarily due to higher sales and the factors noted above that affected gross profit.

Business Segment Results of Operations

The following is a discussion of net sales, operating profit and operating profit margin by business segment which includes a discussion of operating profit and operating profit margin before acquisition integration charges. For additional information related to integration charges see Note 3 to the Condensed Consolidated Financial Statements. For additional information related to acquired businesses see Note 2 to the Condensed Consolidated Financial Statements.

Electrical Americas

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $1,074 | $967 | 11 % | $3,071 | $2,663 | 15 % |
| Operating profit | 156 | 141 | 11 % | 432 | 366 | 18 % |
| Operating margin | 14.5 % | 14.6 % | | 14.1 % | 13.7 % | |
| Acquisition integration charges | $3 | $— | | $7 | $2 | |
| Before acquisition integration charges | | | | | | |
| Operating profit | $159 | $141 | 13 % | $439 | $368 | 19 % |
| Operating margin | 14.8 % | 14.6 % | | 14.3 % | 13.8 % | |

Net sales increased 11% in the third quarter of 2011 compared to the third quarter of 2010 due to an increase of 9% in core sales, an increase of 1% from the acquisition of businesses, and an increase of 1% from the favorable impact of foreign exchange. End markets increased 11% in the third quarter of 2011 compared to the same period in 2010. Net sales increased 15% in the first nine months of 2011 compared to the first nine months of 2010 due to an increase of 11% in core sales, an increase of 3% from the acquisition of businesses, and an increase of 1% from the favorable impact of foreign exchange. The increase in net sales in both the third quarter and first nine months of 2011 was due to strong growth in the markets served by the Electrical Americas segment. Eaton now anticipates its Electrical Americas markets will grow by 8% for all of 2011.

Operating profit before acquisition integration charges in the third quarter of 2011 increased 13% from the third quarter of 2010. Operating profit before acquisition integration charges in the first nine months of 2011 increased 19% from the first nine months of 2010. The increase in both the third quarter and first nine months of 2011 was largely due to higher net sales as noted above. This increase was partially offset by higher raw material and commodity costs, including losses associated with commodity hedge contracts due to significant declines in metal prices primarily during the last two weeks in September. These losses reduced operating margin before acquisition integration charges by 1.0 percentage points.

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Electrical Rest of World

| | Three months ended September 30 | | Increase (decrease) | Nine months ended September 30 | | Increase (decrease) |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | | 2011 | 2010 | |
| Net sales | $755 | $707 | 7 % | $2,285 | $1,980 | 15 % |
| Operating profit | 62 | 81 | (23 )% | 209 | 183 | 14 % |
| Operating margin | 8.2 % | 11.5 % | | 9.1 % | 9.2 % | |
| Acquisition integration charges | $— | $6 | | $1 | $20 | |
| Before acquisition integration charges | | | | | | |
| Operating profit | $62 | $87 | (29 )% | $210 | $203 | 3 % |
| Operating margin | 8.2 % | 12.3 % | | 9.2 % | 10.3 % | |

Net sales increased 7% in the third quarter of 2011 compared to the third quarter of 2010 due to an increase of 7% from the favorable impact of foreign exchange, an increase of 2% from the acquisition of a business, offset by a decrease in core sales of 2%. End markets grew 1% in the third quarter of 2011 compared to the third quarter of 2010. Net sales increased 15% in the first nine months of 2011 compared to the first nine months of 2010 due to an increase of 8% from the favorable impact of foreign exchange, an increase in core sales of 6%, and an increase of 1% from the acquisition of businesses. Eaton now anticipates its Electrical Rest of World markets will grow by 6% for all of 2011. Operating profit before acquisition integration charges in the third quarter of 2011 decreased 29% from the third quarter of 2010. Operating profit in the third quarter was negatively impacted by a large decrease in the residential solar market and losses associated with commodity hedge contracts due to significant declines in metal prices primarily during the last two weeks in September. These losses reduced operating margin before acquisition integration charges by 1.5 percentage points. Operating profit before acquisition integration charges in the first nine months of 2011 increased 3% from the first nine months of 2010 primarily due to higher sales.

Hydraulics

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $717 | $583 | 23 % | $2,130 | $1,641 | 30 % |
| Operating profit | 109 | 76 | 43 % | 335 | 207 | 62 % |
| Operating margin | 15.2 % | 13.0 % | | 15.7 % | 12.6 % | |
| Acquisition integration charges | $1 | $— | | $1 | $— | |
| Before acquisition integration charges | | | | | | |
| Operating profit | $110 | $76 | 45 % | $336 | $207 | 62 % |
| Operating margin | 15.3 % | 13.0 % | | 15.8 % | 12.6 % | |

Net sales in the third quarter of 2011 increased 23% compared to the third quarter of 2010 due to an increase of 13% in core sales, an increase of 7% from the acquisition of businesses and an increase of 3% from the favorable impact of foreign exchange. Global hydraulics markets grew 14% over the third quarter of 2010, with U.S. markets up 18% and markets outside the U.S. up 11%. Net sales in the first nine months of 2011 increased 30% compared to the first nine months of 2010 due to an increase in core sales of 22%, an increase of 4% from the acquisition of businesses, and an increase of 4% from the favorable impact of foreign exchange. Eaton now anticipates its Hydraulics markets will grow by 17% for all of 2011.

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Operating profit before acquisition integration charges in the third quarter of 2011 increased 45% from the third quarter of 2010. Operating profit before acquisition integration charges in the first nine months of 2011 increased 62% from the first nine months of 2010. The increase in both the third quarter and first nine months of 2011 was primarily due to higher sales volumes, partially offset by higher raw material and commodity costs.

Aerospace

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $420 | $390 | 8 % | $1,218 | $1,136 | 7 % |
| Operating profit | 71 | 60 | 18 % | 166 | 157 | 6 % |
| Operating margin | 16.9 % | 15.4 % | | 13.6 % | 13.8 % | |
| Acquisition integration charges | $— | $1 | | $— | $3 | |
| Before acquisition integration charges | | | | | | |
| Operating profit | $71 | $61 | 16 % | $166 | $160 | 4 % |
| Operating margin | 16.9 % | 15.6 % | | 13.6 % | 14.1 % | |

Net sales in the third quarter of 2011 increased 8% compared to the third quarter of 2010 due to an increase in core sales of 7% and an increase of 1% from the favorable impact of foreign exchange. End markets grew 7% in the third quarter of 2011 compared to the third quarter of 2010. Net sales in the first nine months of 2011 increased 7% compared to the first nine months of 2010 due to an increase in core sales of 6% and an increase of 1% from the favorable impact of foreign exchange. Growth in both the third quarter and first nine months of 2011 was primarily driven by higher customer demand in the commercial OEM and aftermarket. Eaton now anticipates its Aerospace markets will grow by 5% for all of 2011.

Operating profit before acquisition integration charges in the third quarter of 2011 increased 16% from the third quarter of 2010. Operating margin before acquisition integration charges increased 1.3 percentage points from 15.6% in the third quarter of 2010 to 16.9% in the third quarter of 2011, reflecting the benefits from higher sales volume and growth in the commercial aftermarket. Operating profit before acquisition integration charges in the first nine months of 2011 increased 4% from the first nine months of 2010. Operating margin before acquisition integration charges decreased 0.5 percentage points from 14.1% in the first nine months of 2010 to 13.6% in the first nine months of 2011. The decrease in the first nine months of 2011 was primarily due to increased expenses stemming from changes in scope, program delays, and execution of new customer programs during the first half of 2011, which were partially offset by the benefits from higher sales volume and growth in the commercial aftermarket.

Truck

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $715 | $534 | 34 % | $1,964 | $1,479 | 33 % |
| Operating profit | 139 | 74 | 88 % | 349 | 179 | 95 % |
| Operating margin | 19.4 % | 13.9 % | | 17.8 % | 12.1 % | |

Net sales increased 34% in the third quarter of 2011 compared to the third quarter of 2010 due to an increase in core sales of 31% and an increase of 3% from the favorable impact of foreign exchange. End markets grew 25% in the third quarter of 2011 compared to the third quarter of 2010. U.S. markets grew 51% while markets outside the U.S. grew 7%. Net sales increased 33% in the first nine months of 2011 compared to the first nine months of 2010 due to an increase in core sales of 28% and an increase of 5% from the favorable impact of foreign exchange. The increase in core sales reflects the continuing rebound in global end markets. Eaton now anticipates its Truck markets will grow by 24% for all of 2011.

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Operating profit in the third quarter of 2011 increased 88% from the third quarter of 2010. Operating profit in the first nine months of 2011 increased 95% from the first nine months of 2010. The increase in operating profit in both the third quarter and first nine months of 2011 was primarily due to higher sales volumes in 2011.

Automotive

| | Three months ended September 30 | | | Nine months ended September 30 | | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | Increase | 2011 | 2010 | Increase |
| Net sales | $442 | $390 | 13 % | $1,348 | $1,153 | 17 % |
| Operating profit | 62 | 39 | 59 % | 167 | 120 | 39 % |
| Operating margin | 14.0 % | 10.0 % | | 12.4 % | 10.4 % | |

Net sales increased 13% in the third quarter of 2011 compared to the third quarter of 2010 due to an increase in core sales of 11% and an increase of 2% from the favorable impact of foreign exchange. The increase in core sales reflects the strong global automotive markets, which grew 8% in the third quarter of 2011 compared to the third quarter of 2010. U.S. markets grew 13% while markets outside the U.S. grew 6%. Net sales increased 17% in the first nine months of 2011 compared to the first nine months of 2010 due to an increase in core sales of 13% and an increase of 4% from the favorable impact of foreign exchange. The increase in core sales in the first nine months of 2011 is due to the same factors noted above. Eaton now anticipates its Automotive markets will grow by 10% for all of 2011.

Operating profit in the third quarter of 2011 increased 59% from the third quarter of 2010. Operating profit in the first nine months of 2011 increased 39% from the first nine months of 2010. The increase in operating profit in both the third quarter and first nine months of 2011 was primarily due to higher sales volumes and the resulting manufacturing efficiencies.

Corporate Expense

| | Three months ended September 30 | | Increase (decrease) | Nine months ended September 30 | | Increase (decrease) |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | | 2011 | 2010 | |
| Amortization of intangible assets | $47 | $46 | 2 % | $143 | $134 | 7 % |
| Interest expense-net | 29 | 33 | (12 )% | 92 | 102 | (10 )% |
| Pension and other postretirement benefits expense | 35 | 30 | 17 % | 105 | 91 | 15 % |
| Other corporate expense-net | 56 | 57 | (2 )% | 155 | 142 | 9 % |
| Total corporate expense | $167 | $166 | 1 % | $495 | $469 | 6 % |

Total Corporate expense increased 1% in the third quarter of 2011 to $167 from $166 in the third quarter of 2010 principally due to a 17% increase in Pension and other postretirement benefits expense related to changes in the discount rate and asset return assumptions for 2011, partially offset by a 12% decrease in Interest expense-net associated with lower interest rates. Total Corporate expense increased 6% in the first nine months of 2011 to $495 from $469 in the first nine months of 2010 due to the same factors noted above.

## LIQUIDITY, CAPITAL RESOURCES AND CHANGES IN FINANCIAL CONDITION

### Financial Condition and Liquidity

Eaton’s objective is to finance its business through operating cash flow and an appropriate mix of equity and long-term and short-term debt. By diversifying its debt maturity structure, Eaton reduces liquidity risk. The Company maintains access to the commercial paper markets through credit facilities that support commercial paper borrowings. There were no borrowings outstanding under these revolving credit facilities at September 30, 2011. Over the course of a year, cash, short-term investments and short-term debt may fluctuate in order to manage global liquidity. Eaton believes it has the operating flexibility, cash flow, cash and short-term investment balances, and access to capital markets in excess of the liquidity necessary to meet future operating needs of the business.

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During the second quarter in 2011, Eaton completed the issuance of $300 floating rate senior unsecured Notes due June 16, 2014. The Company also completed the refinancing of a $500, five-year revolving credit facility which maintains long-term revolving credit facilities at a total of $1.5 billion. For additional information on these financing transactions, see Note 5 to the Condensed Consolidated Financial Statements.

Eaton was in compliance with each of its debt covenants as of September 30, 2011 and for all periods presented.

Undistributed Assets of Non-U.S. Subsidiaries

At September 30, 2011, approximately 79% of the Company's consolidated cash and short-term investments resided in non-U.S. locations. These funds are considered permanently reinvested to be used to expand operations either organically or through acquisitions outside the U.S. The largest growth areas that are expected to require capital are in developing foreign markets such as Africa, Brazil, China, India, the Middle East and Southeast Asia. The Company's U.S. operations generate cash flow sufficient to satisfy U.S. operating requirements. The Company does not intend to repatriate any significant amounts of cash to the U.S. in the foreseeable future.

Sources and Uses of Cash Flow

Operating Cash Flow

Net cash provided by operating activities was $689 in the first nine months of 2011, a decrease of $38 compared to $727 in the first nine months of 2010. Operating cash flows in 2011 were primarily impacted by higher working capital requirements compared to 2010 as well as contributions of $100 to other postretirement benefits plans that were not contributed in 2010. Partially offsetting these uses of cash were higher net income in 2011, which resulted from increased sales due to the global economic recovery that continued in 2011 and the positive effect of recent changes in the Company’s cost structure. For additional information on postretirement benefits plans, see Note 6 to the Condensed Consolidated Financial Statements.

Investing Cash Flow

Net cash used in investing activities was $409 in the first nine months of 2011, a decrease of $23 compared to $432 in the first nine months of 2010. During the first nine months of 2011, capital expenditures increased to $384 in 2011 from $207 in the first nine months of 2010 and cash paid for acquisitions of businesses increased to $298 from $172 in the first nine months of 2010. Higher capital expenditures were due to the Company's increased investments in property, plant and equipment to facilitate growth. These uses of cash were more than offset by cash proceeds of $272 from the sale of short-term investments compared to purchases of $47 in the first nine months of 2010. For additional information on business acquisitions see to Note 2 to the Condensed Consolidated Financial Statements.

Financing Cash Flow

Net cash used in financing activities was $329 in the first nine months of 2011, an increase of $103 compared to $226 in the first nine months of 2010. The increase was primarily due to common share repurchases of $343 during 2011 and an increase of $83 in cash dividends paid in 2011 to Eaton common shareholders, partially offset by proceeds received from a $300 debt issuance completed by Eaton during the second quarter of 2011. Higher cash dividends paid was due to an increase in the quarterly cash dividend paid per common share from $0.29 to $0.34, announced during the first quarter of 2011. For additional information on share repurchases see to Note 9 to the Condensed Consolidated Financial Statements and Part II, Item 2, Unregistered Sales of Equity Securities and Use of Proceeds.

OTHER MATTERS

In December 2010, a Brazilian court held that a judgment obtained by a Brazilian company, Raysul, against another Brazilian company, Saturnia, which was sold by Eaton in 2006, could be enforced against Eaton Ltda. This judgment is based on an alleged violation of an agency agreement between Raysul and Saturnia. At September 30, 2011, the Company has a total accrual of 67 Brazilian Reais related to this matter, comprised of 60 Brazilian Reais recognized in the fourth quarter of 2010 ($32 based on current exchange rates) and an additional 7 Brazilian Reais recognized in 2011 ($4 based on current exchange rates) due to subsequent accruals for interest and inflation. The Company expects that any sum it may be required to pay in connection with this matter will not exceed the amount of the recorded liability. In 2010, Eaton filed motions for clarification with the Brazilian court of appeals which were denied on April 6, 2011. Eaton Holding and Eaton Ltda. filed appeals on various issues to the Superior Court of Justice in Brasilia. On September 27, 2011, the Superior Court of Justice accepted two of the appeals and will hear those appeals

in due course. Another appeal remains pending in the lower appellate court.

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On October 5, 2006, ZF Meritor LLC and Meritor Transmission Corporation (collectively, Meritor) filed an action against Eaton in the United States District Court for Delaware. The action sought damages, which would be trebled under United States antitrust laws, as well as injunctive relief and costs. The suit alleged that Eaton engaged in anti-competitive conduct against Meritor in the sale of heavy-duty truck transmissions in North America. Following a four week trial on liability only, on October 8, 2009, the jury returned a verdict in favor of Meritor. Eaton firmly believes that it competes fairly and honestly for business in the marketplace, and that at no time did it act in an anti-competitive manner. During an earlier stage in the case, the judge concluded that damage estimates contained in a report filed by Meritor were not based on reliable data and the report was specifically excluded from the case. On November 3, 2009, Eaton filed a motion for judgment as a matter of law and to set aside the verdict. That motion was denied on March 10, 2011. On March 14, 2011, Eaton filed a motion for entry of final judgment of liability, zero damages and no injunctive relief. That motion was denied on June 9, 2011. On August 19, 2011, the Court entered final judgment of liability but awarded zero damages to plaintiffs. The Court also entered an injunction prohibiting Eaton from offering rebates or other incentives based on purchasing targets but stayed the injunction pending appeal. Eaton has appealed the liability finding and the injunction to the Third Circuit Court of Appeals. Meritor has cross-appealed the finding of zero damages.

## CRITICAL ACCOUNTING POLICIES

### Goodwill and Indefinite Life Intangible Assets

In September 2011, the Financial Accounting Standards Board issued a revised standard on testing goodwill for impairment. The revised standard allows an entity to first assess the carrying value of goodwill based on qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than the unit's carrying amount. If, based on a qualitative assessment, the fair value of a reporting unit is more likely than not lower than its carrying value, the entity must then test goodwill from a quantitative perspective similar to prior guidance. This standard is effective for 2012, with early adoption permitted. Eaton elected to adopt this standard for its 2011 annual impairment testing.

Goodwill is tested for impairment annually as of July 1 at the reporting unit level, which is equivalent to Eaton's operating segments. As disclosed in Eaton's 2010 Form 10-K, impairment testing for 2010 was performed from a quantitative perspective using a discounted cash flow model to estimate the fair value of each operating segment. For 2010, the fair value of Eaton's reporting units substantially exceeded the respective carrying values.

Impairment testing for 2011 was performed by assessing certain qualitative trends and factors, including projected market outlook and growth rates, forecasted and actual sales and operating profit margins, discount rates, industry data and other relevant qualitative factors. These trends and factors were compared to and based on the assumptions used in the quantitative assessment performed in 2010. For 2011, it is more likely than not that the fair value of Eaton's reporting units continues to substantially exceed the respective carrying amount.

## FORWARD-LOOKING STATEMENTS

This Form 10-Q Report contains forward-looking statements concerning the performance in 2011 of Eaton’s worldwide end markets. These statements may discuss goals, intentions and expectations as to future trends, plans, events, results of operations or financial condition, or state other information relating to Eaton, based on current beliefs of management as well as assumptions made by, and information currently available to, management. Forward-looking statements generally will be accompanied by words such as “anticipate”, “believe”, “could”, “estimate”, “expect”, “forecast”, “guidance”, “intend”, “may”, “possible”, “potential”, “predict”, “project” or other similar words, phrases expressions. These statements should be used with caution and are subject to various risks and uncertainties, many of which are outside Eaton’s control. The following factors could cause actual results to differ materially from those in the forward-looking statements: unanticipated changes in the markets for the company’s business segments; unanticipated downturns in business relationships with customers or their purchases from us; the availability of credit to customers and suppliers; competitive pressures on sales and pricing; increases in the cost of material and other production costs, or unexpected costs that cannot be recouped in product pricing; the introduction of competing technologies; unexpected technical or marketing difficulties; unexpected claims, charges, litigation or dispute

resolutions; strikes or other labor unrest; the impact of acquisitions and divestitures; unanticipated difficulties integrating acquisitions; new laws and governmental regulations; interest rate changes; stock and commodity market and currency fluctuations; and unanticipated deterioration of economic and financial conditions in the United States and around the world. Eaton does not assume any obligation to update these forward-looking statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.
See Note 11 of the Notes to the Condensed Consolidated Financial Statements for changes in exposures to market risk since December 31, 2010.

ITEM 4. CONTROLS AND PROCEDURES.

Pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 (the Exchange Act), an evaluation was performed, under the supervision and with the participation of Eaton's management, including Alexander M. Cutler - Chairman, Chief Executive Officer and President; and Richard H. Fearon - Vice Chairman and Chief Financial and Planning Officer, of the effectiveness of the design and operation of Eaton's disclosure controls and procedures. Based on that evaluation, management concluded that Eaton's disclosure controls and procedures were effective as of September 30, 2011.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in Eaton's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in Eaton's reports filed under the Exchange Act is accumulated and communicated to management, including Eaton's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

There were no changes in Eaton's internal control over financial reporting that materially affected, or is reasonably likely to materially affect, Eaton's internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.
(c) Issuer's Purchases of Equity Securities

8.3 million shares were repurchased in 2011 at a total purchase price of $343. During the third quarter of 2011, Eaton repurchased 7.0 million of the 8.3 million common shares in the open market at a total purchase price of $275. These shares were repurchased under the program announced on January 22, 2007 (2007 Program). A summary of the shares repurchased in the third quarter of 2011 follows:

| Month | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs [1] |
|---|---|---|---|---|
| July | 103,700 | $48.15 | 103,700 | 7,581,870 |
| August | 5,175,419 | 39.62 | 5,175,419 | 2,406,451 |
| September | 1,731,800 | 37.73 | 1,731,800 | 674,651 |
| Total | 7,010,919 | $39.28 | 7,010,919 | |

[1] As adjusted for the two-for-one stock split announced on January 27, 2011

On September 28, 2011, Eaton's Board of Directors approved a 20 million common share repurchase program (2011 Program), replacing the 2007 Program. The 2011 Program authorizes the purchase of up to 20 million shares, not to exceed an aggregate purchase price of $1.25 billion. The common shares are expected to be repurchased over time, depending on market conditions, the market price of common shares, capital levels and other considerations. The 2011 program expires on September 27, 2016. No shares were repurchased under this program in the third quarter of 2011.

ITEM 6. EXHIBITS.
Exhibits — See Exhibit Index attached.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EATON CORPORATION
Registrant

Date: October 26, 2011

By: /s/ Richard H. Fearon
Richard H. Fearon
Vice Chairman and Chief Financial and Planning Officer
(On behalf of the Registrant and as Principal Financial Officer)

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Eaton Corporation
Third Quarter 2011 Report on Form 10-Q
Exhibit Index

| | |
|---|---|
| 3 (a) | Amended Articles of Incorporation (amended and restated as of April 27, 2011) — Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2011 |
| 3 (b) | Amended Regulations (amended and restated as of April 27, 2011) — Incorporated by reference to the Form 10-Q Report for the three months ended March 31, 2011 |
| 4 | Pursuant to Regulation S-K Item 601(b)(4), Eaton agrees to furnish to the SEC, upon request, a copy of the instruments defining the rights of holders of its other long-term debt |
| 12 | Ratio of Earnings to Fixed Charges — Filed in conjunction with this Form 10-Q Report * |
| 31.1 | Certification of Chief Executive Officer (Pursuant to Rule 13a-14(a)) — Filed in conjunction with this Form 10-Q Report * |
| 31.2 | Certification of Chief Financial Officer (Pursuant to Rule 13a-14(a)) — Filed in conjunction with this Form 10-Q Report * |
| 32.1 | Certification of Chief Executive Officer (Pursuant to Rule 13a-14(b) as adopted pursuant to Section 906 of the Sarbanes-Oxley Act) — Filed in conjunction with this Form 10-Q Report * |
| 32.2 | Certification of Chief Financial Officer (Pursuant to Rule 13a-14(b) as adopted pursuant to Section 906 of the Sarbanes-Oxley Act) — Filed in conjunction with this Form 10-Q Report * |
| 101.INS | XBRL Instance Document * |
| 101.SCH | XBRL Taxonomy Extension Schema Document * |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document * |
| 101.DEF | XBRL Taxonomy Extension Label Definition Document * |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document * |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document * |

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* Submitted electronically herewith.

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Income for the three months ended September 30, 2011 and 2010, (ii) Consolidated Statements of Income for the nine months ended September 30, 2011 and 2010, (iii) Condensed Consolidated Balance Sheets at September 30, 2011 and December 31, 2010, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010 and (v) Notes to Condensed Consolidated Financial Statements for the nine months ended September 30, 2011.

In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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